IN THE

SUPREME COURT OF THE UNITED STATES.

October Term, 1941.

Norman Johnson, Suing on Behalf of Himself and All Other Stockholders in The Curtis Publishing Company Similarly Situated Who, Being Interested in the Subject Matter of the Complaint, Shall Become Parties Hereto,

Petitioner,

against

Walter D. Fuller, Mary L. C. Bok, Fred A. Healy, Cary W. Bok, Benjamin Allen, Philip S. Collins, Bruce Gould, Philip S. Rose, Wesley W. Stout, Lewis W. Trayser, John B. Williams, and The Curtis Publishing Company,

Respondents.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

STATEMENT OF THE CASE.

The facts have been set forth in the foregoing petition.

QUESTIONS ARGUED.

The questions to be argued are those presented in the petition and restated as follows:

Point I.

The Circuit Court Erred in Failing to Enjoin Payments on the New Debentures and Prior Preferred Stock.

A.

The decision of the Circuit Court in refusing to enjoin payments on the new securities while accumulated dividends which accrued prior to the plan on the unexchanged preferred stock remained unpaid was apparently in conflict with the law of Pennsylvania as laid down by the Supreme Court of that Commonwealth.

In *West Chester and Philadelphia R. R. Co. v. Jackson,* 77 Pa. St. Rep. 321, where the circumstances as to dividends were analogous to the present case, the Court required the corporation to pay accumulated dividends in full when the initial dividend was declared on a new prior preferred stock. It seems impossible to distinguish that case from the one at bar on the facts. The railroad company had preferred and common stock outstanding, with dividend arrears on the preferred. The company having met with difficulties, obtained authorization by amendment of its charter to create a new issue of prior preferred stock to be given in exchange for the old preferred and accumulated dividends thereon. Stockholders were not obliged under the plan, however, to make the exchange. Plaintiff's intestate continued to hold the original preferred. Finally, the company declared its initial dividend consisting of 4% upon each class of preferred stock. Plaintiff's intestate demanded that all of the accumulations on his shares be paid on the dividend date. The company failed to comply with this demand. The plaintiff then brought an action of assumpsit for an amount equivalent to the accumulated unpaid dividends. Judgment in plaintiff's favor was

affirmed. The Court said that the stockholder's rights were governed by his contract with the corporation and that "his contract rights were precisely defined by the Act of 1855" (327). It was provided in that Act that holders of the preferred stock should be entitled to receive a stipulated rate of dividend "before any interest or dividend shall be paid to the holders of unpreferred stock" (322). Thus, the preference was of the same nature as petitioner's.

Since the Circuit Court based its refusal to grant relief on the theory that petitioner's preference was one only of priority over common stock, petitioner submits that the Circuit Court failed to follow the Pennsylvania law and erred in refusing to enjoin dividend payments on the company's new securities where accumulations remain unpaid on petitioner's shares.

B.

In its opinion, the Circuit Court said:

> "It is also true that the dividends upon the prior preferred stock are given priority of payment over dividends upon the preferred stock which accrued *after* the consummation of the reclassification * * * The appellees contend that the appellant has no vested right in priority under his contract with the company except as to those unpaid dividends which accrued *prior to the completion of the plan* and that he must look for the payment of these dividends to funds lawfully created for that purpose. Under the decisions we do not doubt that his right to the accumulated and unpaid dividends is a vested right." (Opinion, pp. 8, 9.) (Italics ours.)

The law does not deal in empty phrases and petitioner submits that in the light of the above remarks of the Circuit Court, the Court erred in failing to require the payment of dividends accrued prior to the plan before per-

mitting payments to be made on the new securities. The Circuit Court states that petitioner must look for the payment of the accumulated dividends "to funds lawfully created for that purpose." Yet the Court not only approved a plan whereby the equity in all of the defendant Company's funds, including its entire surplus, was diverted forever from the preferred stockholders but it also approved the distribution, through debentures of a large part of those funds to the new securityholders without requiring any amount to be paid to the preferred stockholders who refused to take the new securities.

POINT II.

The Circuit Court of Appeals Erred in Holding That the Plan of Reorganization and Recapitalization Did Not Unlawfully Impair Petitioner's Rights; and in Failing to Hold That the Pennsylvania Business Corporation Law Is Unconstitutional if Interpreted to Permit Said Plan.

A.

1. Petitioner submits that the Circuit Court erred because the 'Plan of Reorganization and Recapitalization" of The Curtis Publishing Company (hereinafter called the "Company") was unlawful as to him because, without his consent, it invaded the rights below mentioned which he was entitled to hold intact.

Stated in the simplest terms, petitioner contends that when a person purchases preferred stock of a corporation, certain rights spring into being, one of which is that the capital and surplus of the corporation (unless diminished by business losses or by distribution pro rata in dividends or on liquidation) will continue to remain behind his stock to safeguard his rights as to dividends and on liquidation; and that any "plan" which, without his consent, causes

such assets to be removed from behind his shares, is unlawful and invalid as to him. Certainly no investor would be disposed to purchase an interest in a company's stock if he knew that the assets composing the security behind his shares were to be eliminated, leaving his equity valueless.

In the present case, there were net assets equivalent to $52.80 behind each share of petitioner's stock before the plan. Immediately after the plan, and by reason of its effect, there were no assets behind petitioner's stock. In fact, the net assets of the Company were insufficient by a wide margin to take care of the new debenture issue and the liquidating rights of the prior preferred stock. The claim of the debentures and the preferential claim on liquidation of the prior preferred stock was approximately $49,750,000, whereas, the Company's net assets were $38,000,000. Against each share of prior preferred stock having a preferential claim on liquidation of $65, plus accrued dividends, there were net assets of approximately $48 per share. Thus, all of the security behind the original preferred stock was drained away by the plan.

It is true that petitioner had the option of exchanging his stock for the new securities against which the Company's assets were being placed. The "option", however, could be exercised only if petitioner waived substantial rights, such as his right to accumulated dividends.

2. Although not questioning that the petitioner holds a vested right to unpaid dividends which accrued prior to the completion of the plan, the Circuit Court held (erroneously as petitioner contends) that the petitioner's rights as a preferred stockholder are limited strictly to a preference over common stockholders.

The point now under discussion can best be illustrated as follows: The defendants have asserted in the Courts be-

low, and the Circuit Court has held, that the unalterable rights of preferred stockholders in this case consist of:

> (1) The right to receive currently accruing dividends, or, in the event of liquidation, the right to receive $100 per share plus accrued dividends before corresponding payments may be made to common stockholders;
>
> (2) The right to receive payment of accumulated unpaid dividends before dividends may be paid to common stockholders.

The Circuit Court has held that since the above rights have not been disturbed in a literal sense, the reorganization is valid since it was adopted under Article VIII of the Business Corporation Law of 1933 of Pennsylvania (15 P. S. Pa. Section 2852-801 (4)), which permits reclassification of shares (Opinion, pp. 13, 14). Petitioner claims, however, that his inalienable rights are more extensive and include not only the two abovementioned but also the following:

> (3) The right to have the corporate assets employed exclusively for corporate purposes—and particularly in this case, the right to restrain direct or indirect employment of the corporate assets for the benefit of controlling stockholders to the detriment of minority, non-consenting stockholders;
>
> (4) The right to parity with all other preferred stockholders of the same class so far as treatment by the corporation is concerned.

As shown above, the Company assets in their entirety in this case have been shifted away from dissenting stockholders, not for the accomplishment of any corporate purpose, but only for the admitted purpose of bettering the position of the common stockholders.

Likewise, petitioner has not been treated on a parity with other preferred stockholders. It is fundamental that a dividend may not be paid to some preferred stockholders while others of the same class remain unpaid. *Cratty v. Peoria Law Library Ass'n,* 219 Ill. 516, 76 N. E. 707; *Godley v. Crandall & Godley Co.,* 212 N. Y. 121, 105 N. E. 818. The distribution of debentures in this case amounted to a dividend. It is true that under the plan the petitioner could have received his proportionate share of debentures but only if he gave up his vested right to accumulated dividends amounting to substantially more than the debentures being offered to him. It cannot be truly said that the right to receive a dividend on the basis of equality with others of the same class exists where the dividend will not be paid unless the stockholder waives valuable vested rights.

3. It appears to have been conceded by the Circuit Court that vested rights are inalienable and not subject to divestment under the Business Corporation Law of Pennsylvania. The Circuit Court erred in not recognizing that the rights mentioned in the second box, supra, are inalienable vested rights as well.

This Court and other Courts have discussed "vested rights," but apparently have nowhere defined that term. For illustration:

In *Stokes v. Continental Trust Company,* 186 N. Y. 285, the Court held that the right of preferred stockholders to a proportionate share of the corporate surplus is an inherent and vested right of property.

In *Keller v. Wilson,* Del. 190 Atl. 115, it was held that the right of a preferred stockholder to accumulated dividends is a vested right of property secured against destruction by the Federal Constitution.

In *Coombes v. Getz,* 285 U. S. 434, the accrued right of a corporation's creditor to hold a director personally liable to him, up to the amount of his debt, for funds embezzled from the corporation was held "vested" and inalienable although the statute under which the right was asserted was repealed before the creditor obtained judgment. In that case, the Court said at 441, 442:

> "The authority of a state under the so-called reserved power is wide; but it is not unlimited. The corporate charter may be repealed or amended, and, within limits not now necessary to define, the interrelations of state, corporation and stockholders may be changed; but neither vested property rights nor the obligation of contracts of third persons may be destroyed or impaired."

In *Matter of Kinney,* 279 N. Y. 423, 18 N. E. (2d) 645 (a case of recapitalization involving a "voluntary" exchange of preferred for prior preferred stock, the waiver of accumulated dividends and a reduction of capital just as in the present case), the Court upheld dissenting stockholders' rights to appraisal of their shares. The Court said:

> "When this sum * * *, amounting to about one-third of the capital of the corporation, was transferred from capital to surplus, the eight-dollar cumulative preferred stock lost its right to rely upon this portion of capital * * *. The reduction in capital constitutes a material alteration of the preferential rights of the old preferred * * *" (279 N. Y. at 431).

In *Chicago, M. St. P. R. R. Co. v. Wisconsin*, 238 U. S. 491, the Court stated, at p. 501:

> "In the brief of counsel for the State it is argued that the statute can be sustained as a valid exercise of the State's reserved power to alter the charter of the Company. That question does not seem to have been raised in the state court, nor was its decision based on that proposition. Indeed such a ruling would seem to have been opposed to State ex rel. Northern Pacific v. R. R. Commission, 140 Wisconsin, 157, and the Water Power Cases, 148 Wisconsin, 124, where it was held that the right to amend a charter does not authorize the taking of the Company's property without just compensation. The same view has been repeatedly expressed in the decisions of this court. For example, in Shields v. Ohio, 95 U. S. 324, it was said that 'the power of alteration and amendment is not without limit. *The alterations must be reasonable* * * * *and consistent with the scope and object of the act of incorporation.'* * * * Again in Stearns v. Minnesota, 179 U. S. 223, 259, it was held that *the reserved right to amend a corporate charter 'does not confer mere arbitrary power, and cannot be so exercised as to violate fundamental principles of justice by* * * * *taking of property without due process of law.'* Lake Shore &c. Ry. v. Smith, 173 U. S. 690; Stanislaus Co. v. San Joaquin Co., 192 U. S. 201; Sinking-Fund Cases, 99 U. S. 720; Miller v. State, 15 Wall. 498; * * *" (Italics ours.)

It is petitioner's contention that the plan which deprived him without his consent of all the assets and security behind his shares, invaded his vested rights to enjoy the benefits of such assets and security on a parity with all preferred stockholders, and that the Circuit Court erred in failing so to hold and to invalidate the plan as to him, or otherwise to hold unconstitutional the statute which countenanced it.

POINT III.

The Circuit Court Erred in Failing to Follow the Principle of Southern Pacific Co. v. Bogert, 250 U. S. 483, and Jones v. Missouri-Edison Electric Co., 144 Fed. 765, Certiorari Denied 229 U. S. 615.

The record discloses with unusual frankness that the dominant-common-stock-management called for a sacrifice by the preferred stockholders and promulgated the plan for their own benefit. The Company's treasurer testified that although the Company's surplus was very large it was the opinion of the management that the preferred stockholders "would be milking the company" if the surplus funds were used to pay accumulated preferred stock dividends (83). Witnesses produced by the defendants testified that it was the purpose of the plan to improve the position of the company's common stockholding management who otherwise might try "to make money in other ways" which would be "entirely unfortunate from the point of view of a preferred stockholder" (86, 93, 95, 96). The company's credit position was so "superlatively good" (87) that there was no "financial stringency" (91) which required any plan of reorganization.

In these circumstances, it is plain that the plan did not serve any valid corporate purpose. It is true that the equity in the Company's assets was shifted to the holders of the new debentures and prior preferred stock and not to the common stockholders. It is true also that petitioner's priority of claim still ranks ahead of the common stockholders. The result and the stated intendment of the plan, nevertheless, was to eliminate as much as possible of the accumulated dividends so that the common stockholders might receive dividends sooner than if the accumulated

dividends were to be recognized and paid in full. In order to accomplish this, the preferred stockholders had either to give up substantial rights if they accepted the plan, or see their equity entirely vanish and their prospect of receiving dividends grow so remote as virtually to be meaningless. It is this of which petitioner complains.

The facts, in addition, throw doubt upon the bona fides of the management who in submitting the plan to stockholders claimed that it was advisable to eliminate rather than pay the accumulated dividends. The fact is that the same management, instead of paying the dividends, used $5,938,137 of the Company's surplus to purchase the Company's own shares in the market, and an additional $6,700,000 in the issuance of debentures under the plan. Had these amounts been applied to the payment of dividends to the class as a whole, the accumulations would have been practically paid up in full.

Petitioner asserts, therefore, that the Circuit Court erred in refusing to find the plan invalid by reason of the action of the dominant common stockholders in benefiting themselves to the disadvantage of the preferred stockholders.

POINT IV.

The Circuit Court Erred in Failing to Invalidate the Plan Because of Its Failure to Recognize and Apply the Rule of Priority.

In *Petry v. Harwood Electric Co.*, 280 Pa. St. Rep. 142, 124 Atl. 302, where a merger had occurred, appraisers appointed under the statute found a value equal to par and accumulated dividends for preferred shares held by a dissenting stockholder. Under the merger plan common stock-

holders received common stock of the surviving corporation. The Supreme Court of Pennsylvania upheld the valuation, stating as one of its main grounds:

> "If there were not sufficient assets to pay the preferred stockholders par and accrued dividends, then, as against the common stockholders, the preferred ones were entitled in the merger to get all of the stock distributable to the defendant company, and the common stockholders would not be entitled to receive any of it. As a matter of fact, the common stockholders received for their stock in the defendant company large holdings of stock in the merged company. They could not justly and equitably deny to the preferred stockholders that which was due to them, and at the same time hold on to the stock of the new company which they had received because of their ownership of common stock in the defendant." (280 Pa. at 156.)

Thus, in a merger as distinguished from an equity reorganization, the Court recognized and gave expression to the priority rule of *Northern Pacific Co. v. Boyd* and subsequent equity decisions.

In the present case, although for many years and at the time of the plan there was a large surplus freely used as such by the company, there was no equity whatever for the common stockholders. This was admitted by the defendants (85) and was stated by the Company's accountants in the balance sheet submitted with the plan (41).* The explanation for this apparent paradox lies in the fact that the company carried its stated capital at a figure far

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* The audited balance sheet states:

"The excess of the Preferred Stock Liability amounts to $47,179,053.49
Common Stock, No Par Value Shares in hands of Public, 1,730,101
Liquidating Liability Nothing"

below the liquidating preference of the preferred stock. Not only was there no equity for the common stock but the Company's treasurer emphatically stated that it would never be possible for the Company to acquire sufficient net assets to redeem the preferred stock (72) or pay it off in full on liquidation (85). In spite of this situation the common stockholders received new common stock, share for share, in the reorganization.

In view of the decision in *Petry v. Harwood Electric Co.*, supra, it seems probable that the priority rule in essence would be deemed applicable by the appellate courts in Pennsylvania. Moreover, the current evolution of corporate law as exemplified by the decisions of this Court in *Case v. Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106, and *Consolidated Rock Products Co. v. DuBois*, 312 U. S. 510, as well as the interesting decision of the Securities & Exchange Commission in the recapitalization case of Federal Water Service Corporation et al., Holding Company Act Release No. 2635, March 24, 1941, point in the direction of judicial and administrative insistence that junior securityholders be dealt with according to rank where the rights of classes are shuffled.

In the present case, we have the extraordinary situation of the Company's so-called top heavy capitalization being cured by cutting it off at the top. This runs violently counter to all principles of fairness. Petitioner submits, therefore, that even were the law to permit recapitalization in proper cases along the general lines of the plan in the present case, the Circuit Court erred in refusing to find that the plan in this case is unfair and unlawful. If the decision in this case remains undisturbed, the institution of preferred stock hitherto considered as a medium of in-

vestment may well be eliminated, for the safeguards with which investors thought themselves surrounded are, as it seems, largely illusory.

It is not to be overlooked that the situation presented by this case is relatively new insofar as it exemplifies action which is being undertaken by many corporations today. It is only through this Court that an authoritative rule can be laid down for the guidance of investors and corporations alike.

CONCLUSION.

It is respectfully submitted that the questions involved in this application are of great importance to investors throughout the United States and that such questions require the exercise of this Court's supervisory jurisdiction by writ of certiorari.

Respectfully submitted,

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